The Big Picture

Investment Research
28 November 2022

Recession with different undercurrents

Highlights

- Various shocks challenge the global economy, with different undercurrents driving the economic outlook across regions
- The euro area and the US are headed for recession, while the Chinese growth engine is sputtering
- Inflation pressures slowly recede, allowing central banks to gradually exit tightening mode
- Risks primarily stem from renewed geopolitical tensions, energy shocks and a return of the pandemic through new variants

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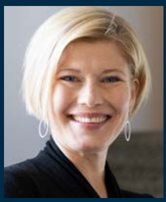

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The Big Picture is focusing on the outlook for the global economy.
Read more about the prospects for Nordic economies in our Nordic outlook publication.

Important disclosures and certifications are contained from page 35 of this report.

Global overview

Inflation sticks and a recession comes

- Multiple shocks continue to give the global economy a beating and we expect both the euro area and the US economies to enter a recession during in the coming quarters.

- There are substantial differences in both depth and duration of the recession following the very different shocks that have hit both economies. In the US we see a more traditional recession triggered by policy tightening, while in the euro area the situation is more complex due to a combination of an energy supply side shock and monetary policy tightening pushing down demand.

- Inflation falls back during 2023, but remains at elevated levels all throughout the year. Central banks will soon start to exit hiking mode and rate cuts could be on the agenda for 2024.

- The geopolitical situation following Russia's war of aggression on Ukraine continues to be challenging for Europe and energy rationing remains a key downside risk. Inflation that stays high for longer and a housing market crisis are also noteworthy risks. A return of the pandemic through new variants continues to be high on the risk agenda, as are renewed tensions relating to Taiwan.

Not one global story, but many

The global economy is in many ways in a troublesome situation. Many shocks of different character – Russia's war of aggression in Ukraine, energy shortages, material and labour shortages, historically high inflation, rapidly increasing interest rates and continued zero-Covid policy in China - have created a global setup where there is not only one synchronized cycle and key story to tell, but many stories of a more regional character.

The euro area is on the brink of a recession that we expect will linger in 2023. Energy shortages and very high energy prices challenge companies and households, pushing down both production and consumption for a prolonged period of time. The energy-related problems are not a one-winter struggle for Europe, but a structural hurdle that will take years to clear. On top of this, geopolitical uncertainty, persistent inflation pressures and lingering supply shortages in some areas create a challenging concoction for the global growth outlook. Supportive fiscal policy packages, aiding companies and households struggling with high energy costs, combined with rapidly tightening monetary policy create an in-optimal policy mix. The US economy in turn has a simpler setup, with something resembling a classical policy tightening cycle triggering a recession, but also the prospect of a more rapid rebound. China, with its zero-Covid policy and domestically driven challenges, continues to struggle, but will in the medium-turn return to a more normal growth path and pent-up demand is expected to lead to above-trend growth in 2024.

Inflation, and how central banks plan to tackle it, continues to be one of the most central themes for the global outlook. Many of the initial inflation drivers stemming from supply side problems, such as shipping costs, the inventory cycle and raw material costs, have fallen back considerably lately, pointing towards significant global deflationary pressures going forward. On the other hand, labour demand is still outstripping supply keeping wage pressures high in the US as well as in Europe, offsetting some of the deflationary forces. In Europe, energy costs are also instrumental for inflation developments during the coming year.

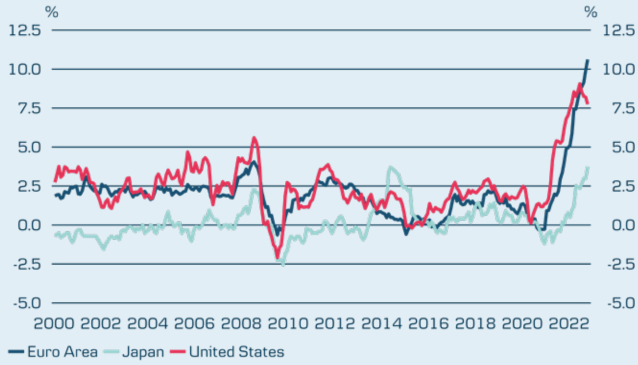
Although we expect inflation on both sides of the Atlantic to stay elevated throughout 2023, we look for it to gradually come down and that central banks move out of their hiking mode. We expect neither the Fed nor the ECB, to hike policy rates beyond the first quarter of 2023, reflecting the forward-looking nature of monetary policy. As inflationary pressures recede during 2023 and 2024 and the economic outlook weakens, we see it as most likely that central banks will again start cutting rates in early 2024, which is slightly later than what markets are pricing in currently.

A key assumption we make in this forecast is that we assume Russia's war of aggression in Ukraine will continue. This assumption adds a negative tilt to our euro area forecast.

Key forecasts: Recession is coming

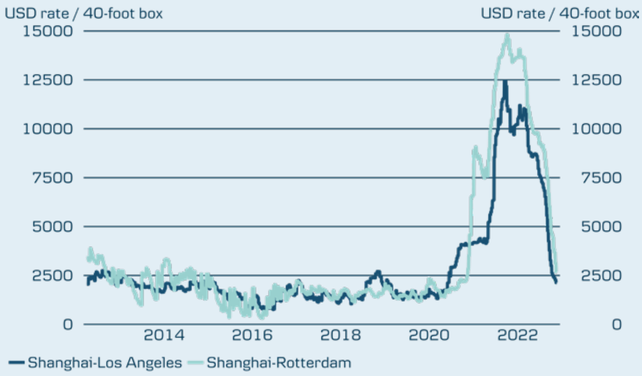
The key building blocks of our global forecast are that both the euro area and the US will enter a recession during the coming

Headline inflation continues to be extremely high both in the euro area and the US



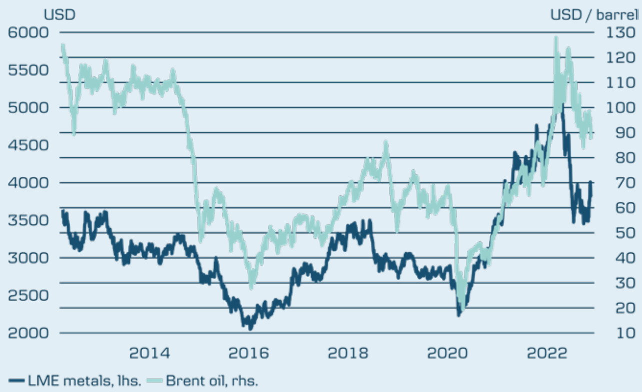
Sources: Macrobond Financial, Danske Bank

A rapid normalisation has taken place during autumn in shipping rates, creating deflationary pressures



Sources: Bloomberg, Danske Bank

A significant normalisation from peak levels has taken place in many raw materials



Source: Bloomberg, Danske Bank

quarters, inflation will prove sticky, but gradually recede over the forecasting period and energy-related problems in Europe will be with us for at least 3-4 years.

We expect the euro area to enter negative growth territory already during the last quarter of 2022. We forecast euro area GDP growth at -0.9% in 2023 and 0% in 2024. Our forecast builds on the assumption that energy-related issues will become smaller during the summer 2023, but will again resurface when the cold season closes in next autumn. Delayed effects of ECB monetary tightening as well as spill-overs from the US recession through the export channel also drive our expectation of a double dip recession during the winter of 2023/24.

We expect US GDP growth to be -0.2% in 2023, after which it rebounds to 0.5% in 2024. In contrast to Europe, we do not foresee similar structural headwinds for the US from energy shortages and high energy prices. One risk to look out for, though, is the sharp slowdown in the housing market, with house prices now falling from elevated levels.

China continues to struggle with its both internal and external challenges. Its zero-Covid policy and property market crisis dampens the growth outlook from a domestic perspective, while we expect China to suffer significantly from fading foreign demand due to recessions both in the US and the euro area. In 2023, we expect the economy to grow 4.9% followed by 5.3% in 2024, as we look for pent-up demand to be unleashed once China leaves the zero-Covid policy behind in the second half of 2023.

The outlook for emerging economies is challenging given the tightening of global financial conditions, an overall stagnating world economy and a stronger US dollar. We see the latest risk rally, and easing in financing conditions, as premature. We think emerging economies will struggle to catch up, especially those that were already lagging behind in the global post-pandemic recovery story.

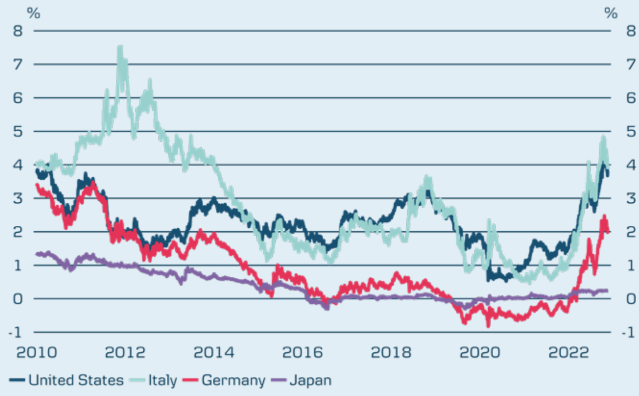
Inflation will fall back during the coming years, but we expect that process to be rather slow. In the US, we forecast CPI inflation to stay at 4.5% in 2023 and to fall below 2% only in 2024. In the euro area, inflation will stay higher for longer due to the energy price challenges. Euro area HICP inflation is set to average 7.6% in 2023 and 3.2% in 2024 in our view.

A complex risk picture

The economic situation continues to be plagued by exceptional uncertainty. Hence, we present two alternative scenarios in this outlook; one where inflation falls back more rapidly and one where inflation is stickier than what we expect in our baseline. Generally we see that risks are tilted to the downside, but that there also are significant upside risks.

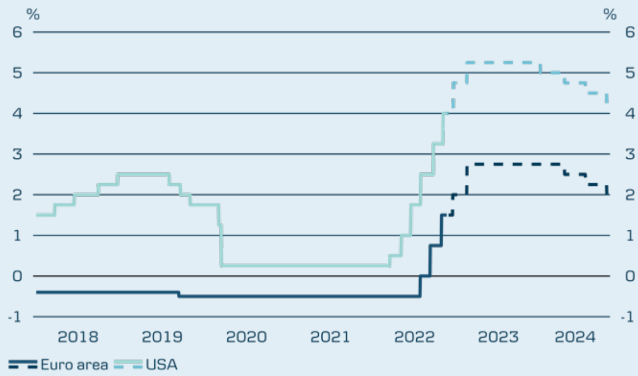
On top of the mainly inflation-related risks presented below, geopolitical risks are also considerable, which we elaborate more in our focus on p.15 “Geopolitical tensions and the risk of hybrid attacks cast a shadow on Europe”. Another high-risk issue is the energy situation in Europe, where downside risks dominate. Although we see the probability of energy rationing

10y government bond yields close to 4% both in the US and in Italy



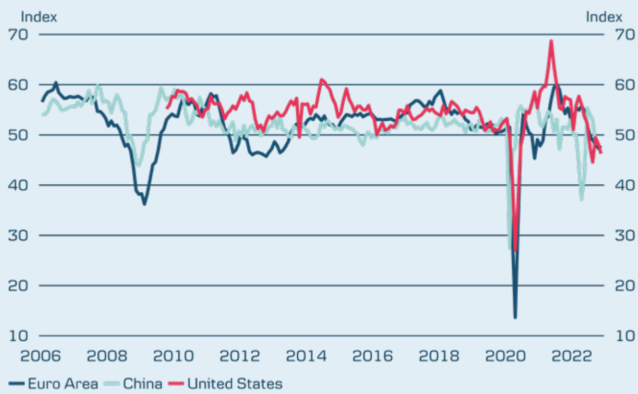
Source: Macrobond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future results

The largest increases have already been seen in key policy rates, but some hikes are expected also in early 2023



Source: Macrobond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future results

PMI: Purchasing manager indices indicate a slowing global economy



Source: Markit, Macrobond Financial, Danske Bank being required in Europe as relatively small, such a scenario would have devastating consequences for the economy (see also "What does gas rationing mean for the economy?" p. 19). The return of the pandemic through new variants continues to be a risk on a global scale. There are also risks related to the rapidly increasing interest rates, both for sovereigns, corporates and households coupled with high and increasing debt levels. The risk of a hard landing in housing markets in both the US and Europe is real, as prices increased substantially in the past couple of years, but have now started to fall on the back of a sharp deterioration in affordability following the substantial rise in mortgage rates.

Risk scenarios

Central banks are tightening financial conditions at a historically rapid pace. Monetary tightening works with a lag and thus we do not know the full effect on the economy until at least a year after the last rate hike. That makes it extremely difficult to dose monetary policy correctly and it leaves a significant risk of triggering a deeper recession than intended.

Downside

In the downside scenario, global inflation pressures increase more than expected in the short-term. A global driver could be recurring Covid-19 lockdowns in China adding to supply chain issues. A cold winter triggering natural gas shortage and production shutdowns, particularly in Europe, could be another one. In this scenario, central banks step up monetary tightening even further than in the base case. The hit to private demand is amplified by weakening financial markets as bond yields spike, equities fall, and property markets decline sharply. High inflation and higher interest payments squeeze households' real incomes further causing consumer spending to decline along with investments. Unemployment increases more rapidly than in the base case.

As demand declines and the temporary inflation shock wears off, inflation declines rapidly. Thus, central banks start to cut rates again in early 2024 to support the economy. Poor consumer sentiment lingers though, following the erosion of purchasing power, deteriorating financial markets and decline in home equities. The global economy starts to recover six months later than in the base case. We have assigned 25% probability to this scenario.

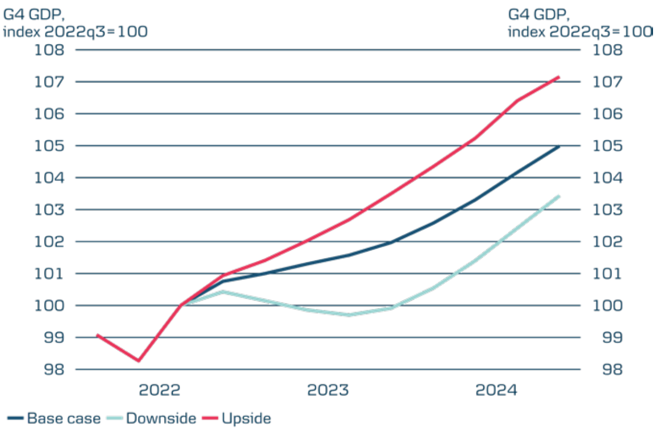
Upside

Considering the high uncertainty to the economic outlook, there are of course also upside risks. In the upside scenario, we assume that the recent significant decline in the global inflation impulse, from easing supply chain pressures, declining commodity, food prices and freight rates, starts to dominate CPI figures. That allows central banks to ease the tightening pace, which lowers bond yields and boosts equity markets. Consumer sentiment increases and consumers run down a large proportion of the savings accumulated during the crisis. We have assigned 10% probability to this scenario.

G4 GDP growth, %	2023	2024
Base case	1.6	2.2
Downside	0.4	2.0
Upside	2.7	3.2

Source: Danske Bank, Oxford Economics' Global Economic Model

Risks are skewed to the downside



Source: Danske Bank, Oxford Economics' Global Economic Model

Real GDP forecasts - Global overview

	2023				2024							
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2021	2022	2023	2024
	% q/q				% q/q				% y/y			
G4	0.2	0.3	0.2	0.4	0.6	0.7	0.8	0.8	6.5	2.7	1.6	2.2
US	0.0	-0.6	-0.5	0.0	0.3	0.3	0.5	0.6	6.0	1.9	-0.2	0.5
Euro Area	-0.7	0.1	-0.4	-0.6	-0.2	0.4	0.7	0.3	5.3	3.3	-0.9	0.0
China	1.0	1.2	1.3	1.3	1.3	1.3	1.3	1.3	8.6	3.3	4.9	5.3
Japan	0.1	0.0	0.0	0.1	0.4	0.3	0.3	0.3	1.7	1.4	0.7	0.9

Source: Macrobond Financial, Danske Bank

US

Recession looming in 2023

- The US economy continues to face rapid inflation stemming from aggregate demand remaining too high. The Fed will continue to tighten financial conditions and push the US economy towards a recession starting in Q2 2023. We expect US GDP to contract by 0.2% in 2023 followed by a gradual recovery of 0.5% in 2024.

- While macro momentum has clearly cooled over the recent months, the US economy still remains on a path of modest growth towards the winter, supported by strong exports and resilient private consumption.

- Risks remain tilted towards inflation pressures turning out more persistent than expected, and thus we expect the Fed to take a cautious approach in eventually easing its monetary policy stance. We expect the Fed Funds rate to rise to 5.00-5.25% in February 2023, and look for four 25bp cuts only in 2024.

The near-term outlook for the US economy appears challenging, as growth momentum has cooled during the second half of 2022. GDP growth rebounded from the technical recession of H1 as expected, but the recovery was almost exclusively driven by positive contribution from net exports, largely reflecting declining imports. US households' consumption is still affected by lingering pandemic effects, as goods demand has remained unusually high relative to services. The gradual normalization will continue to weigh on imports, while the high energy demand from Europe will bolster exports even amid broader growth slowdown in the global economy.

The underlying growth outlook has still weakened on a broad basis towards the fall, as private consumption growth continues to moderate. Gasoline prices have declined from the early summer peak levels, but the rebound in consumers' purchasing power has not supported demand as much as expected. In addition, rapidly rising interest rates are now beginning to weigh on investments. Housing markets have cooled off markedly, and residential investments will increasingly act as a drag on growth towards next year.

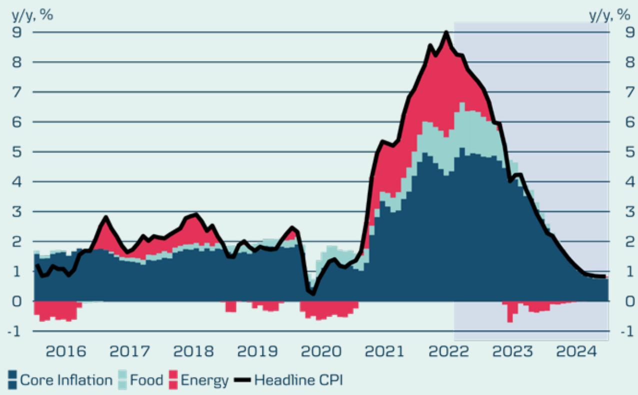
Despite the gloomy outlook, the overall economy still remains in decent shape compared to the euro area. The US has become a net exporter of energy, thus benefiting from high energy price levels. Consequently, domestic natural gas and electricity prices have not risen to the same extent as in Europe. American consumers have only recently begun to use up the large pile of cumulative excess savings from the pandemic and past stimulus packages. While declining asset prices are now also weighing on households' wealth, the savings have so far provided a strong buffer for consumption.

As a result, US real private consumption remains close to is pre-Covid trend. Besides the accumulated savings, fast wage inflation has also provided support for consumption amid rapidly rising prices. Throughout the pandemic, labour shortages have been the most acute in lower paying sectors, and especially leisure & hospitality, where wages have risen by almost 20% since the beginning of 2021. Together with the stimulus checks, fast wage inflation has supported consumption also among lower-income groups.

Rapidly rising wages remain an issue from an inflation perspective, however. US labour supply remains clearly below its pre-Covid trend, which together with resilient private consumption suggests, that the output gap remains positive despite the recent easing in growth momentum. Compared to the euro area, US inflation stands out as demand-driven and broad-based. The most stable components on inflation have remained at elevated levels, likely reflecting pass-through from rising labour costs. In October, wages rose at a monthly pace of 0.4% SA, or almost 5% annualized - clearly above levels consistent with Fed's inflation target and very high in light of the looming recession.

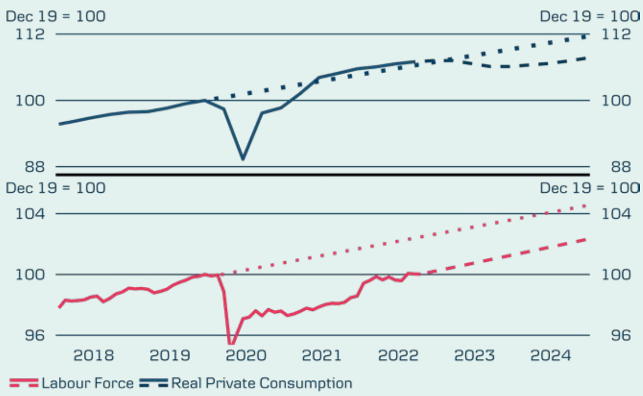
As a result, the Federal Reserve continues tightening its monetary policy. We expect the Fed to deliver one more 75bp hike in the December meeting, followed by a final 50bp hike in February, which would set the Fed funds rate at 5.00-5.25%.

US inflation increasingly driven by core CPI



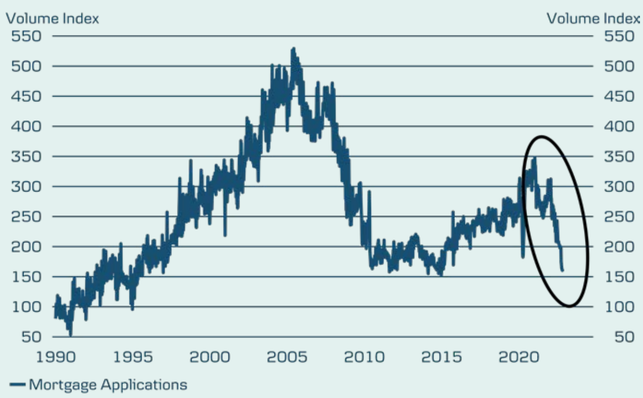
Sources: Macrobond Financial, U. S. Bureau of Economic Analysis (BEA), Danske Bank

Fed needs to close the positive output gap in order to bring inflation down



Sources: Macrobond Financial, U. S. Bureau of Economic Analysis (BEA), Danske Bank

Residential investments will become a drag on growth amid cooling housing markets



Sources: Macrobond Financial, Mortgage Bankers' Association (MBA)

Modest growth turns into a recession in Q2 2023

We expect growth to continue moderating towards early 2023, and the US economy to eventually fall into recession in Q2. Fed has acknowledged the asymmetric balance of risks in terms of controlling inflation, and emphasized that modest recession is preferred over allowing inflation pressures to persist for any longer than necessary. Overtightening the economy into a recession can be followed with a quick turn towards easier monetary policy if needed, but a stagflationary period of high inflation, tight monetary policy and rising unemployment would be more difficult to deal with.

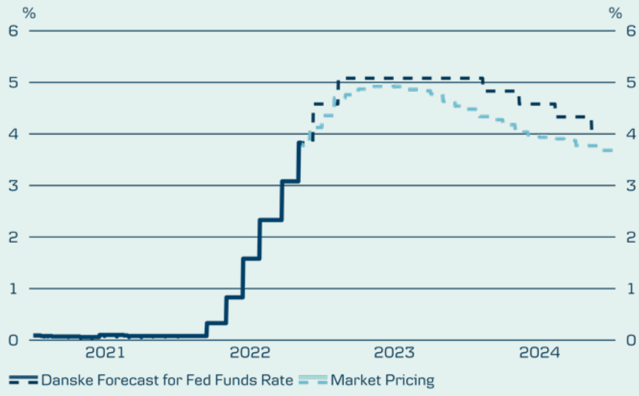
Once the output gap has been closed by a modest recession during 2023, the US economy looks set for a gradual recovery towards 2024. The US does not face similar structural growth headwinds stemming from the energy shortages as the euro area, and the Fed can allow growth to rebound once the economy has reached a new equilibrium with lower demand. For now, we pencil in only a modest pace of recovery after the recession, with private consumption growth approaching its potential only towards summer of 2024. We expect US GDP to contract by 0.2% in 2023 followed by a recovery of 0.5% in 2024. We also expect the unemployment rate to rise to 5.5-6.0% in 2024, which would still reflect fairly modest weakening in labour market conditions compared to past recessions.

As we have highlighted earlier in Research Global - High inflation flashbacks, 5 September, inflation as fast as seen today has historically taken several years to stabilize back to the 2% target. Thus, we expect the Fed to approach the upcoming easing cycle cautiously. We do not expect the Fed to cut rates in 2023, and only look for four 25bp rate cuts in 2024. As seen in July and early August this year, as soon as markets begin to speculate with upcoming rate cuts amid looming recessionary signs, financial conditions can also begin to ease clearly before the actual rate cuts materialize.

The Fed has emphasized that while the lag of monetary policy transmission remains uncertain, financial conditions will need to be maintained at restrictive levels for longer, which suggests that the hawkish communication will last at least until realized inflation begins to clearly moderate. Pre-emptive easing in financial conditions could rapidly spark new waves of commodity-driven inflation, and given that we expect the Chinese economy to recover towards the second half of 2023, a risk of a renewed rise in commodity prices could coincide with the US falling into a recession next year. Worryingly, while realized inflation eased in October, both market- and consumer-survey based inflation expectations have ticked higher. Consequently, the past tightening seen in real financial conditions has stalled since October.

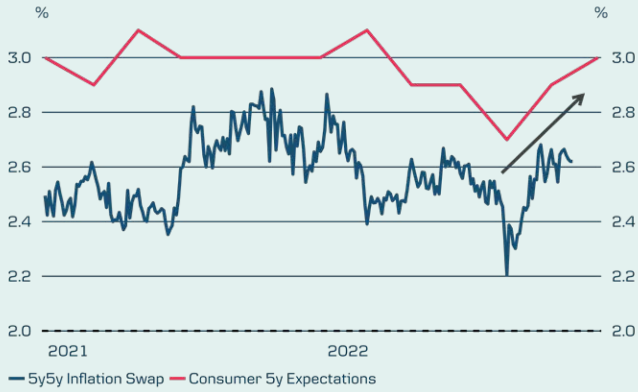
For now, the decline in commodity prices seen so far and easing supply chain challenges have not translated into clearly lower core goods consumer prices, which to us is just another sign of demand remaining too high. Core Goods CPI declined in October, but the move largely reflected reversal of past rises in used car prices, which have not been a key inflation driver in 2022. We reviewed why we do not see the October CPI as a

We expect Fed to maintain rates higher for longer than market anticipates



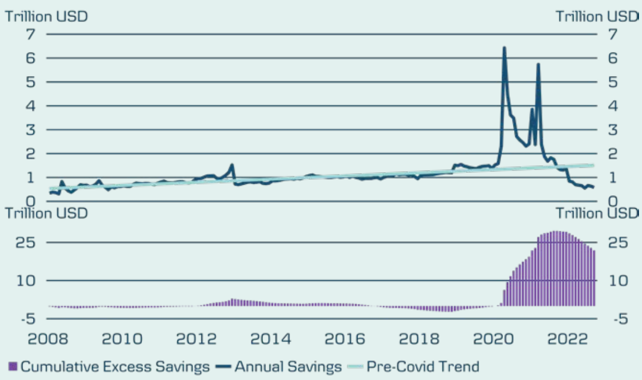
Sources: Macrobond Financial, CME, Danske Bank
Note: Past performance is not a reliable indicator of current or future results

Inflation expectations have ticked higher recently



Sources: Macrobond Financial, University of Michigan, Refinitiv
Note: Past performance is not a reliable indicator of current or future results

High savings will continue to support modest private consumption growth through winter



Sources: Macrobond Financial, U. S. Bureau of Economic Analysis (BEA), Danske Bank turning point for inflation in Research US - Inflation risks are not over yet, 11 November.

Interpreting services inflation is complicated by the delayed rise in shelter and healthcare prices. House prices rose rapidly following the strong monetary and fiscal easing at the beginning of the pandemic, and as rents are typically adjusted either annually or at the beginning of new rentals, past rises in housing prices are only now feeding into the consumer price index. The owner-occupied housing costs in the US CPI are also estimated based on rental costs, and we expect the positive impact to last until around mid-2023.

A similar positive impact is seen in healthcare inflation, where the rapid rise in labour costs continues to feed into the CPI with a lag. As housing prices have already turned lower amid higher mortgage rates, shelter prices will have a deflationary impact on core CPI starting from the end of 2023. Naturally, that might not reflect the true underlying inflationary pressures in the economy at the time, if the Fed fails to supress aggregate demand sufficiently or if commodity prices turn higher irrespective of demand from the US.

In any case, assuming that both shelter and healthcare related inflation pressures ease by mid-2023, and the recession starts to truly weigh on firms' purchasing power around the same time, both headline and core CPI should come down clearly during H2 2023. Easing labour market conditions and higher unemployment should also limit further rises in wages, supporting the outlook for more moderate consumer price inflation. We see inflation declining below the Fed's 2% target in 2024 due to the negative contribution from shelter prices, but stress that risks remain tilted towards underlying price pressures remaining more persistent than expected. We expect headline CPI to average 4.5% in 2023 and 1.7% in 2024.

Macro forecasts - US

	2023				2024						
% change q/q AR	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2022	2023	2024
GDP	0.0	-2.5	-1.8	0.1	1.1	1.2	1.9	2.4	1.9	-0.2	0.5
Private Consumption	0.0	-2.0	-2.0	0.0	1.0	1.0	1.6	2.0	2.6	-0.2	0.4
Private Fixed Investments	-5.2	-8.8	-5.4	-0.5	1.5	3.3	5.1	6.6	-0.4	-5.4	0.6
Residential	1.1	-6.0	-4.8	-0.9	1.1	2.9	4.8	6.1	3.4	-0.7	0.6
Non-residential	-25.2	-18.5	-7.8	1.0	3.0	5.1	6.1	8.2	-10.5	-20.4	0.8
Change in inventories[1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.7	-0.3	0.0
Public Consumption	1.0	1.0	1.6	1.6	1.4	1.0	1.0	1.0	-0.9	1.1	1.3
Exports	1.2	-9.6	-9.6	0.0	2.0	3.0	4.1	4.1	7.9	1.1	-0.1
Imports	-3.9	-8.7	-8.7	1.0	2.4	3.4	4.5	4.5	8.5	-4.4	0.5
Net exports[1]	0.2	0.1	0.1	0.0	0.0	-0.1	-0.1	-0.1	-0.6	1.0	-0.1
Unemployment rate (%)	3.6	3.7	4.0	4.7	5.2	5.6	5.8	5.9	3.6	4.0	5.6
Inflation (CPI) (y/y)	6.4	4.8	3.8	2.9	2.3	1.8	1.4	1.3	8.1	4.5	1.7
Core inflation (CPI) (y/y)	6.0	5.4	4.6	3.9	3.0	2.2	1.6	1.4	6.2	4.9	2.0
Public Budget[2]									-4.2	-3.8	-3.9
Public Gross Debt[2]									124	121	121
Current Account[2]									-3.9	-3.1	-2.8
Fed funds rate[3]	5.25	5.25	5.25	5.25	5.00	4.75	4.50	4.25	4.75	5.25	4.25

1. Contribution to annualised GDP growth
2. Pct. of GDP (CBO and IMF)
3. Upper limit, end of period
Source: CBO, IMF, Danske Bank

Euro area

Double dip recession

- The economic challenges facing the euro area are not the same as in the US. Supply side shocks set the scene for an extended period of high inflation coupled with lacklustre growth. A recession seems difficult to avoid and we expect GDP to decline by 0.9% in 2023, followed by stagnation in 2024.

- Elevated inflation pressures coupled with the risk of de-anchoring inflation expectations will keep the ECB firmly in tightening mode. Rate cuts could be on the cards in 2024, but uncertainty remains high.

- Europe's biggest fragility stems from the (geo)political front, as well as a renewed flaring up of the energy crisis or new Covid-19 outbreaks next winter. Upside risks to the growth outlook arise from pandemic-related private savings buffers, fiscal measures and accelerated investment spending.

- 'Stagflation' does not have to be the new normal, but structural reforms to address low productivity and adverse demographic trends as well as securing a leading position in the green transition race remain key.

Another winter, another downturn

With its geographical proximity to Russia and Ukraine, heavy reliance on energy imports and high integration in global value chains, the euro area economy is facing the perfect storm. The catch-up potential from the pandemic seems increasingly exhausted in many sectors. Consumers have turned historically gloomy and real spending is trending down. Waning demand and rising input costs are slowly taking their toll on production. A recession seems difficult to avoid and we now expect GDP to decline by 0.9% in 2023, followed by stagnation in 2024. Declining private consumption will be the main driver for the growth slowdown over the winter, as the real income squeeze exerts its full force in 2023. Following a temporary uptick in the growth momentum towards the summer, we expect another downturn in the second half of 2023, as both the lagged impact from ECB's monetary tightening and spill-overs from the US recession take effect through the export channel.

Downside risks mainly stem from the geopolitical front (see theme box) as well as a renewed flaring up of the energy crisis or new Covid-19 outbreaks next winter. On the other hand, pandemic-related private savings buffers, fiscal measures and accelerated investment spending on defence and the green transition remain upside risks for the growth outlook.

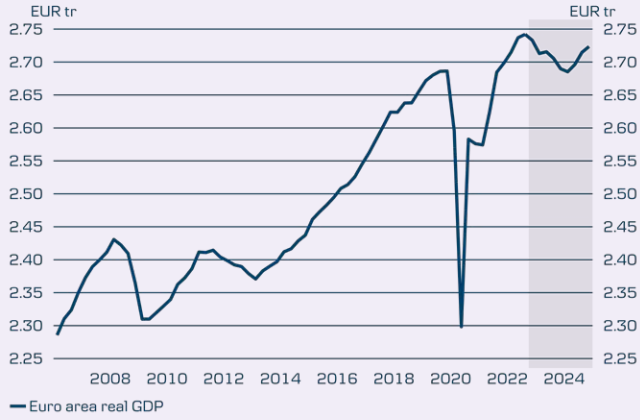
Balancing debt and productive investments

During 2022, governments have set up various programmes to help households and firms cope with higher energy prices. These programmes are costly and have often not yet been fully accounted in the 2023 budget plans. The recession is going to be a further drag on public finances, as are higher interest expenditures due to rising government bond yields. Overall, we think the fiscal stance will stay roughly neutral in 2023, but taking into account the large off-balance sheet spending, fiscal policy might end up being expansionary, especially if additional measures are rolled out during 2023.

Thanks to strong nominal growth, debt to GDP ratios will continue to fall in 2022, but start growing again from 2023 onwards, illustrating the fiscal sustainability challenges Europe faces. While the Stability and Growth Pact rules remain suspended during 2023, discussions about EU fiscal rules reform should gather pace in H1 23. Current proposals foresee individual member states getting a bigger say in their debt reduction plans, with extra time granted for justified investments and structural reforms, while also strengthening enforcement. In the coming years, governments will have to walk a fine line between managing their rising debt piles, while allowing for productive investments, especially fiscally vulnerable ones like Italy.

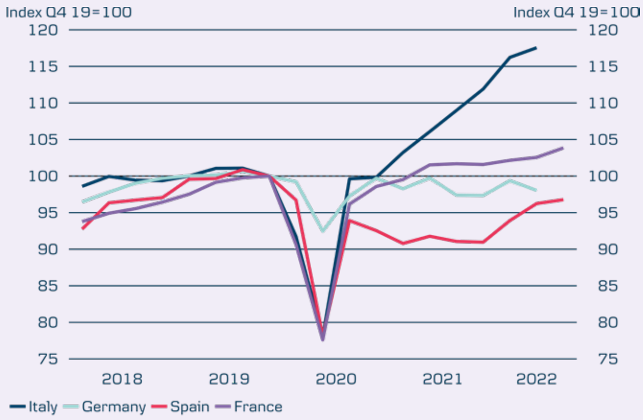
'Next Generation EU' (NGEU) funding will continue to play a key role in levelling the economic playing field between euro area countries and according to ECB estimates will boost euro area GDP by around 0.5pp in 2023 and 2024. Under its REPowerEU plan, the Commission has also outlined additional investment needs of EUR 210bn until 2027. But although there is now a drive to fast-track the approval and construction of renewable energy, the EU's electricity grid might not expand fast enough and blackouts and gas rationing remain a clear possibility also next winter.

Double dip recession



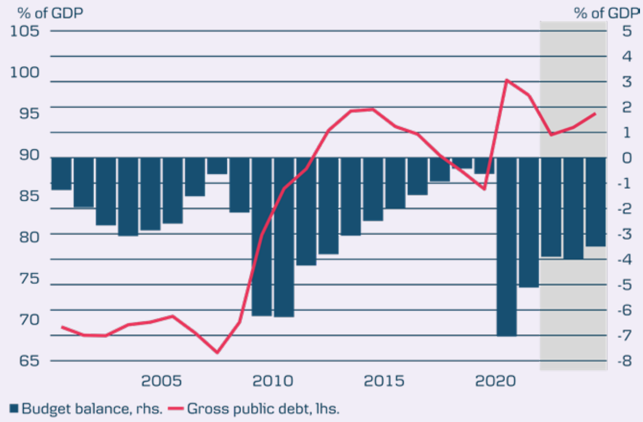
Source: Eurostat, Macrobond Financial, Danske Bank

Upside risks from NGEU-financed investments



Source: Eurostat, Macrobond Financial, Danske Bank

Fiscal sustainability challenges remain



Source: EU Commission, Macrobond Financial, Danske Bank

Inflation remains sticky...

Euro area labour supply was quicker to return to pre-pandemic levels than in the US, but labour shortages remain widespread. The economic downturn should cool labour demand and lead to a moderate uptick in unemployment on the back of rising bankruptcies and production relocations abroad. Nevertheless, we do not look for a large-scale labour market crisis, which should support ongoing wage growth.

Firms continue to pass-on higher input costs to consumers and in spite of the recession, we expect this process of cost-push inflation to extend into 2023, keeping price pressures elevated for longer. Despite the moderation in natural gas and electricity prices, delayed pass-through to household bills will mean energy price inflation will abate only gradually, while the downside risk from price caps seems limited. Core inflation will also prove sticky in our view, due to second round effects from higher energy, material, but also labour costs. Our forecasts are above current market pricing and show headline inflation returning to the ECB's target not before the end of 2024, with the green transition and higher than expected wage growth still presenting upside risks.

... with no monetary easing in sight before 2024

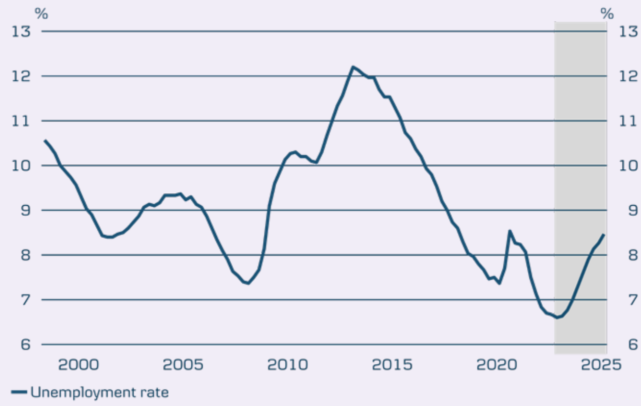
Elevated inflation pressures coupled with the risk of de-anchoring inflation expectations will keep ECB firmly in tightening mode, despite the growing recession risk. Monetary tightening will be achieved both through balance sheet normalisation and the policy rates channel. Following further rate hikes in the coming months, we expect the deposit rate to peak at 2.75% in early 2023 and remain in restrictive territory throughout next year. Rate hikes will be accompanied by quantitative tightening (QT) in early 2023, with Fed-style capped reinvestments of maturing bonds under the APP programme, as well as tightening liquidity conditions via maturing TLTROs.

Rising borrowing costs and tightening credit standards will take its toll on e.g. construction investment and a housing crisis remains a key downside risk for the growth outlook. The prospect of a double dip recession, combined with clear signs of easing underlying inflation pressures over the medium-term opens up the possibility of ECB rate cuts in 2024, with QT likely also being phased out, but uncertainty about the global central bank outlook remains high.

Political fragilities

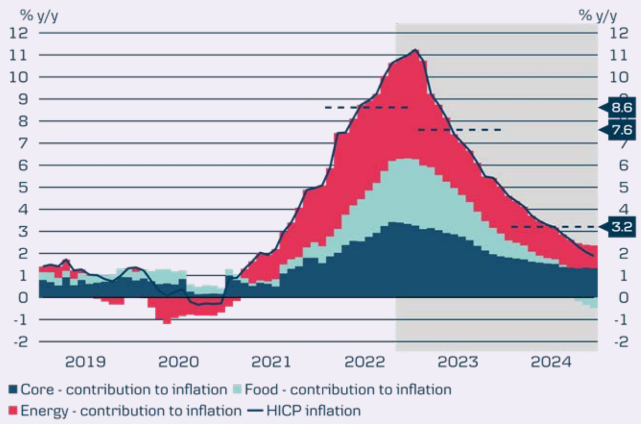
The economic challenges facing the euro area are not the same as in the US. But on balance its supply side shocks are even more difficult to address with monetary tightening alone and will likely result in an extended period of high inflation coupled with lacklustre growth. Europe can, and eventually will, end its reliance on Russian energy, but the transition will be painful and take time. In the meantime, Europe's biggest fragility stems from the political side, not only from fragmented fiscal policies, but also growing divisions how to address long-term challenges such as climate change or global trade. 'Stagflation' does not have to be the new normal in our view, but structural reforms to address low productivity and adverse demographic trends as well as securing a leading position in the green transition race remain key.

Moderate uptick in unemployment



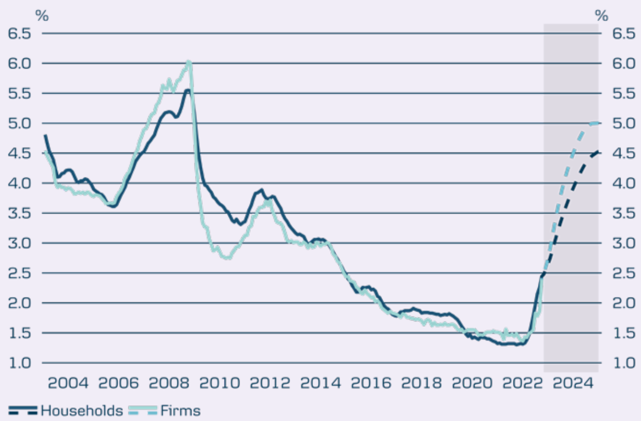
Source: Eurostat, Macrobond Financial, Danske Bank

Inflation to return to ECB's target not before 2024



Source: Eurostat, Macrobond Financial, Danske Bank

Rising borrowing costs will weigh on growth



Source: ECB, Macrobond Financial, Danske Bank

Macro forecasts - Euro area

% Change q/q	2023				2024				Calendar year average			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2021	2022	2023	2024
GDP	-0.7	0.1	-0.4	-0.6	-0.2	0.4	0.7	0.3	5.3	3.3	-0.9	0.0
Private Consumption									3.7	3.9	-1.6	0.7
Fixed Investments									3.7	2.5	-1.0	-0.2
Public Consumption									4.3	1.0	0.7	1.7
Exports									10.5	6.6	2.0	1.2
Imports									8.3	6.4	2.1	2.7
Unemployment rate (%)	6.9	7.2	7.5	7.8	8.1	8.2	8.4	8.6	7.7	6.7	7.4	8.3
HICP (y/y)	10.4	8.1	6.6	5.3	4.4	3.5	2.9	2.1	2.6	8.6	7.6	3.2
Core HICP (y/y)	4.7	4.3	3.8	2.9	2.6	2.3	2.1	2.0	1.5	3.9	3.9	2.2
Public Budget[1]									-5.1	-3.9	-4.0	-3.5
Public Gross Debt[1]									97.2	92.4	93.3	95.0
ECB deposit rate[2]	2.75	2.75	2.75	2.75	2.75	2.50	2.25	2.00	-0.5	2.0	2.75	2.0

1. Pct. of GDP
2. End of period
Source: Eurostat, Danske Bank

Geopolitical tensions and the risk of hybrid attacks cast a shadow on Europe

Russia's war of aggression against Ukraine is going through a period of escalation following Ukraine's latest battlefield successes. Mobilisation of conscripts, 'scam' referenda and the illegal annexation of four Ukrainian oblasts are both acts of desperation, but also clear signals that the Kremlin's strategy remains one of doubling down, not backing off.

Currently, there is no room for diplomacy and we expect the war to drag on. Ukraine's leadership has been explicit about their goals: they are not only aiming to deter Russia, but also restore the borders that pre-date Russia's illegal annexation of Crimea back in 2014. Considering its remarkable advance, Ukraine has no reason to negotiate a ceasefire – neither does Russia, which is the underdog now. Russia's objectives remain unclear, but it has not given any signals that original goals have changed, despite the apparent underperformance. At this point, Russia would not be able to secure terms favourable enough through diplomacy, let alone spin its 'special operation' as a victory.

It is in Russia's interests to seek a stalemate. While the Russian economy and its army will be weakened by the sanctions in the long term, in short term time is on its side, with new conscripts soon joining the frontline. Russia is likely counting on Western interest towards Ukraine to fade over time. In terms of funding, the US remains the single largest contributor to Ukraine and its role in supporting Ukraine's military is crucial. For now, we expect no change in the US stance: though significant in absolute terms, as a share of US GDP, its contribution is only around 0.25%. We doubt it would be the first target on any Republican cost-cutting agenda.

Rising household energy bills will be a first test for European solidarity, with some polls already showing growing public support among European countries for renewed peace negotiations. But it is likely that Russia will aim to exert even more pressure on Europe by means of hybrid warfare: cyber-attacks are already common, but also the risk of sabotage against critical infrastructure should not be ignored. The European energy market has no leeway for the coming winter and any unexpected shocks would cause severe disruption, triggering higher prices and raising the risk of blackouts and rationing, with devastating consequences for the economy.

Germany

'Zeitenwende'

- Challenging times lie ahead for Germany's economy, as the three pillars of its old economic success model – industry, globalisation and cheap energy imports – have become its weakness.
- Until the energy crisis is resolved, Germany is unlikely to return as the euro area's economic powerhouse anytime soon. We expect a recession to take hold over the winter and extend further into next year.
- Inflation pressures will remain elevated in 2023, amid rising wage growth and delayed energy price pass-through.
- Stepped up investments on infrastructure, digitalisation and the green transition are an upside risk, and not least an interesting business opportunity for Nordic firms offering solutions in these areas.

On the hunt for a new growth model

Challenging times lie ahead for Germany's economy, as the three pillars of its old economic success model – industry, globalisation and cheap energy imports – have become its weak spot. Strong order books, easing supply chain stress and pent-up consumer demand kept the economy afloat in 2022, but we think it is increasingly fighting gravity. Cracks in domestic demand have started to appear and especially industry is struggling to maintain its competitiveness amid rising cost pressures and more fragile global supply chains.

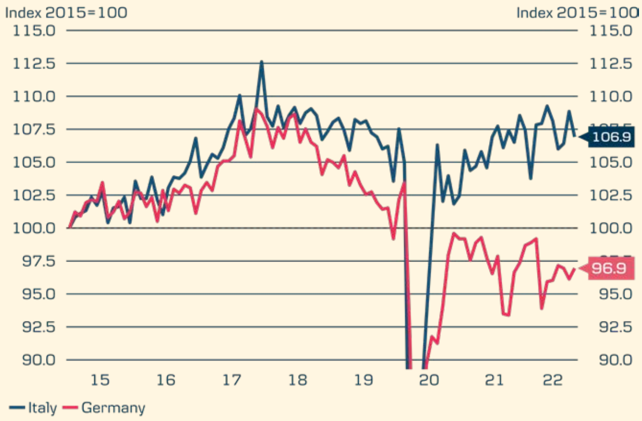
The energy crisis will continue to cast a shadow over the economy also next winter. Re-filling gas storage without Russian supplies will be difficult, leaving the risk of gas rationing (see theme box) still lurking in the background. That said, energy infrastructure investments and a large scale adoption of renewables have finally gotten political focus. On top of three planned LNG terminals, six Floating Storage Regasification Units are being set up along Germany's coasts, with three expected to start operating already in early 2023. To achieve the goal of an 80% renewable power share by 2030 (from 45% today), onshore wind capacity is targeted to rise five-fold and solar capacity four-fold from current levels. Faster planning processes and higher support for rooftop solar power complement the measures, although regional public resistance remains an issue.

Adverse demographics remains one of the biggest structural challenges for the German economy, as the workforce is projected to shrink by more than five million people by 2035. A declining workforce, combined with labour hording and furlough schemes will likely support the labour market, but we still expect to see an increase in unemployment from the current record low levels. Near-term, the tight labour market, combined with rising consumer inflation expectations should support a noticeable uptick in negotiated wage growth in 2023 to levels of 4-5%, followed by more moderate wage increases in 2024. Due to the delayed pass-through of gas and electricity prices, German consumers will likely continue to face further energy price increases in the coming months.

In sum, the outlook for the German economy is clouding and we expect a recession to take hold at the end of 2022. Domestic demand will increasingly feel the impact of falling real disposable incomes and higher borrowing costs, while weaker foreign demand will weigh on net exports. Fiscal support measures and a relatively resilient labour market will help to mitigate the downturn, but overall we revise the outlook for GDP growth down to -1.4% in 2023 and -0.5% in 2024, with a nascent recovery only taking shape from Q2 24 onwards as real incomes start to grow again.

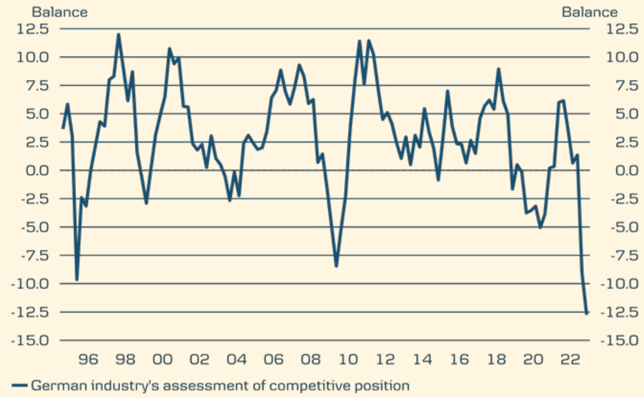
Until the energy crisis is resolved, Germany is unlikely to return as the euro area's economic powerhouse anytime soon. Germany has entered a phase of adjustment and reinvention that is pushing it to refocus and turn inward. This has created a power vacuum on the European political stage, as the souring Franco-German ties attest. Germany's lack of policy coordination over fiscal measures has antagonized many EU partners and efforts to restart the old mercantilist China policy (see theme box) are increasingly raising eyebrows in Brussels and Washington.

Industrial production has not grown since 2015...



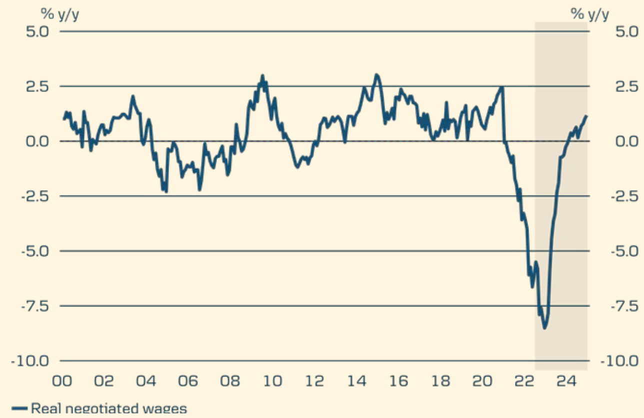
Source: Destatis, Istat, Macrobond Financial, Danske Bank

... and energy crisis is further weighing on competiveness



Source: EU Commission, Macrobond Financial, Danske Bank

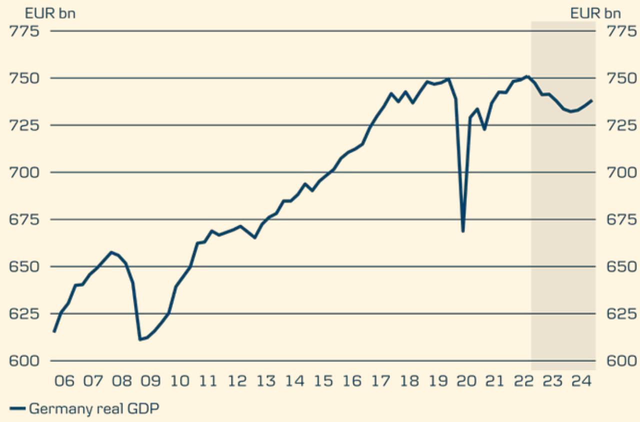
High inflation is eroding consumers' purchasing power



Source: Bundesbank, Eurostat, Macrobond Financial, Danske Bank

The long-term growth prospects of the German economy remain mixed. Productivity growth has been declining for several decades, as innovation expenditures are increasingly concentrated on large companies. With technological change and the transition to a climate-neutral economy, many German industries will have to adapt their business models and production processes, not least the important car sector. To kickstart its growth prospects, Germany needs a 'Zeitenwende' (paradigm shift) beyond foreign and security policy. With globalisation slowing – or turning into 'friendshoring'– the economy has to adjust to a world, where services grow in importance relative to industrial exports. Stepped up investments on infrastructure, digitalisation and the green transition provide a silver lining, and not least an interesting business opportunity for Nordic firms offering solutions in these areas, but they will also require the clearing of bureaucratic hurdles and as well as public support e.g. for the adoption of digital solutions.

A lacklustre growth outlook



Source: Eurostat, Macrobond Financial, Danske Bank

The China connection

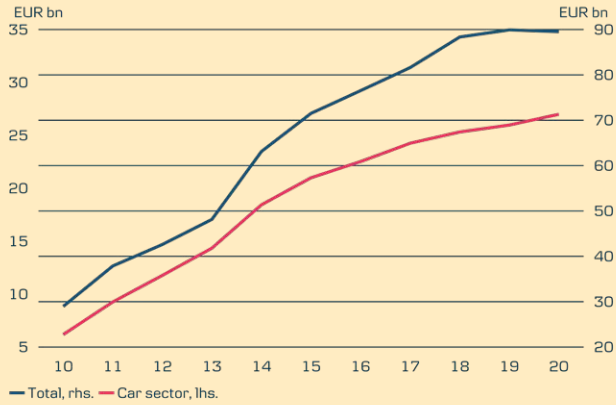
For years, German companies prospered from China's appetite for machinery, chemicals and cars. China remains Germany's largest trading partner and nearly half of German manufacturers rely on intermediate inputs from China (three-quarters for car industry). Sino-German trade supports more than one million jobs directly and of Germany's ten most valuable listed companies, nine derive at least 10% of revenues from China (compared to two in America).

Waking up to the reality of Russian energy blackmail, Germany's growing China dependencies have started to raise questions. The government's new "China Strategy" will likely include clear messages on the need to reduce dependencies and diversify supply chains and trading partners. Berlin has already signalled it will offer fewer guarantees to insure companies against political risks in China. That said, deep divisions persist between the Greens and parts of the SPD about the future of the relationship.

Many companies are taking a closer look at their dependencies amid growing concerns about China's sabre-rattling over Taiwan and continued economic disruptions caused by its zero-Covid policy. Nearly half of German manufacturers that receive significant inputs from China plan to reduce their Chinese imports according to the Ifo Institute. However, while many SMEs are looking to diversify their supply chains away from China, Germany's old industrial giants remain reluctant to leave the Chinese market.

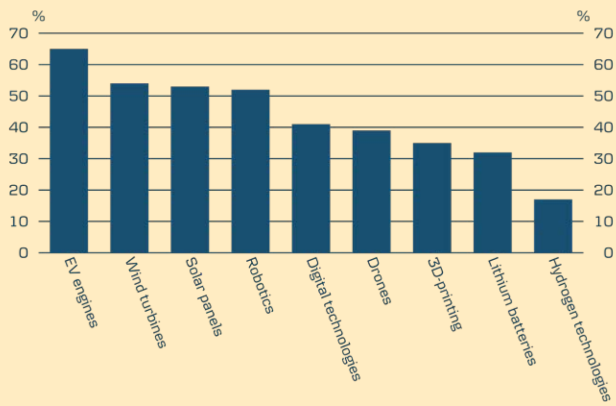
German companies leaving the Chinese market in droves remains unlikely. China remains a leading supplier of rare earths and many technologies that will be key for a successful green transition. That said, as the Chinese global growth engine is shifting into lower gear, the days of China being a one-way bet are gone. A successful diversification of German industry into alternative suppliers and export markets will be an important building block for future proofing the growth model, but it also leaves upside risk for more persistent inflation pressures from 'efficiency losses' during the transition phase.

German FDI into China has stagnated, but continues to increase for car producers



Source: Bundesbank, Macrobond Financial, Danske Bank

China is a large supplier for EU imports of green transition raw materials and technologies



Source: EU Commission, Ifo

Macro forecasts - Germany

% Change q/q	2023				2024				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2022	2023	2024
GDP	-0.8	0.0	-0.5	-0.6	-0.2	0.1	0.3	0.4	1.7	-1.4	-0.5
Private Consumption									4.5	-2.3	0.9
Fixed Investments									0.3	-1.2	0.0
Public Consumption									3.4	1.7	2.3
Exports									1.7	1.4	-0.1
Imports									5.5	2.1	3.0
Unemployment rate (%)	3.3	3.6	3.9	4.2	4.2	4.2	4.2	4.2	3.0	3.8	4.2
HICP (y/y)	11.8	8.8	7.2	5.7	4.5	3.7	3.1	2.3	9.0	8.4	3.4
Public Budget[1]									-2.3	-1.8	-1.0
Public Gross Debt[1]									67.4	67.5	66.2

1: Pct. of GDP
Source: Eurostat, Danske Bank

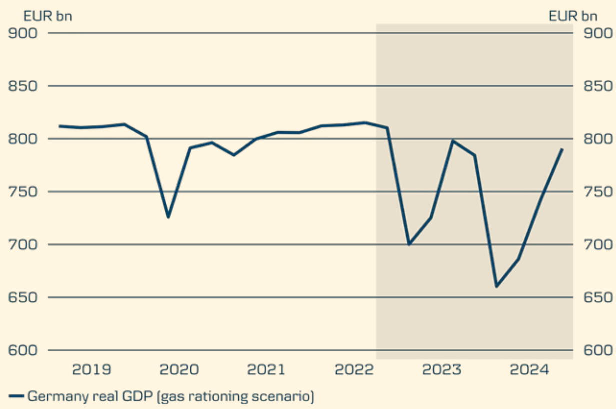
What does gas rationing mean for the economy?

Ever since Russia curtailed gas supplies via the North Stream 1 pipeline, concerns about German energy shortages this winter have been mounting. A combination of factors, such as the weather, the availability of alternative energy supplies and the behavioural response of households and firms (who account for two-thirds of gas consumption) will determine whether gas rationing and blackouts can be avoided this winter.

Refilling of gas storage has occurred faster than expected, with most targets met roughly two months in advance. Diversification efforts as well as energy savings measures have been stepped up and gas consumption currently lies 20-30% below average, which is also partly due to warm weather. Still, it is too early to declare victory as continued high LNG deliveries to Europe are by no means assured and storage levels cover only roughly 2-3 months of demand during the peak heating season.

In case of a shortfall in gas supplies, the Federal Network Agency will determine supply for different sectors. Protected customer groups such as households, essential social services and district heating systems would be the last to experience rationing, while ‘non-essential’ energy-intensive manufacturing sectors such as chemicals, base metals, paper and glass will be most exposed. Gauging the economic consequences of such a drastic intervention is a difficult exercise, as no historical precedent exists. However, model simulations by German think tanks find devastating consequences for the German economy, which could trigger a decline in GDP by almost 8% in 2023 and more than 4% in 2024, an even deeper economic hit than during the Covid-19 pandemic.

Sharp decline in GDP in case of gas rationing



Source: Destatis, Gemeinschaftsprognose

UK

The recession is here

- Q3 GDP figures marked an official start of the recession and the economy is likely to weaken further from here. We expect negative GDP growth for four consecutive quarters. Positive growth will not to return until the fourth quarter of 2023. The unemployment rate will increase to 5% by the end of the forecast period.

- Mortgage rates are pushed higher by a higher central bank rate and political turmoil will most likely be persistently higher. Housing markets have been strong during the pandemic, but due to higher interest rates and a weakening economy, we expect a drop in housing prices of approximately 8% from the top.

- Inflation pressures will remain elevated during 2023, forcing the Bank of England to deliver further hikes. We do however see the peak rate well below market pricing and we expect the first cut to be delivered during 2024.

The UK economy has entered the recession

The UK economy is facing multiple shocks. Inflation is running too high, eroding household purchasing power, as wage growth has been slower than inflation growth. At the same time, the UK is struggling with the energy crisis just like the euro area and with tighter financial conditions followed by higher central bank rates as well as higher government bond yields. The UK economy held up during the first half of 2022, but the Q3 GDP figure marked an official start of the recession in our view, as the economy is likely to weaken further. We expect negative GDP growth for four consecutive quarters and growth not to return until the fourth quarter of 2023. We now see the economy contracting by 0.7% in 2023 followed by a modest 0.8% growth in 2024.

The labour market has remained strong with the unemployment rate at a very low level, currently at 3.6% s.a, which is below Band of England's assessment of the long-term equilibrium rate of unemployment of around 4%. Due to the strong demand for labour, wage growth has remained too high at 6%, well above what is consistent within Bank of England's inflation target at 2%. However, we do see some first signals of labour demand starting to soften in survey indicators such the PMI. The vacancy rate also seems to have reached the peak and has started to decrease, although it remains at a very high level. As the UK economy has entered a recession in our view, we do see an increase in the unemployment rate in the coming two years and expect the unemployment rate to be at 5.0% at the end of the forecast period.

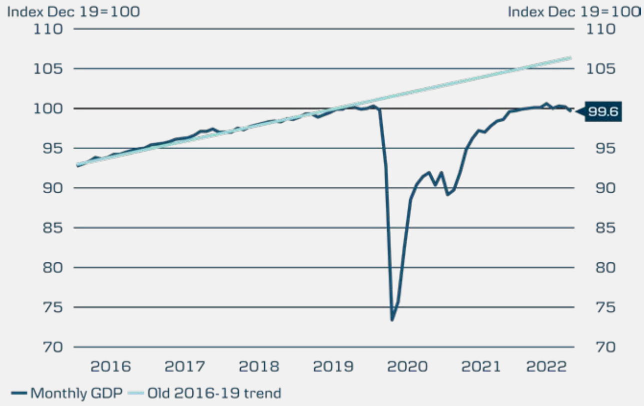
The political turmoil in the UK has probably not been missed by anyone. Prime Minister Liz Truss had to resign and Rishi Sunak stepped in, communicating a much more restrictive fiscal policy and introduced tax increases across the board to close the fiscal gap. This is good news in inflation terms, but will hit the broader economy further. In light of the political turmoil, mortgage interest rates have increased to levels not seen since the financial crisis, hitting especially homeowners that need to refinance their loans or those entering the housing market. So far, housing prices have moderated by 0.9% since the top in August, but will most likely fall further the coming quarters. We estimate a drop in housing prices by approximately 8% during 2023, which would take prices back to October 2021 levels.

Inflation to gradually decrease

Inflation pressure remains too elevated and printed at 11.1% in October. One big driver to the October print was the new energy price cap that was set at an annual GBP 2500, up from the earlier cap at GBP 1971. The current price cap will run until April next year and will thereafter be increased to GBP 3000 running for 12 months. Without the price cap, inflation in October would have been even higher, at 13.8% according to ONS.

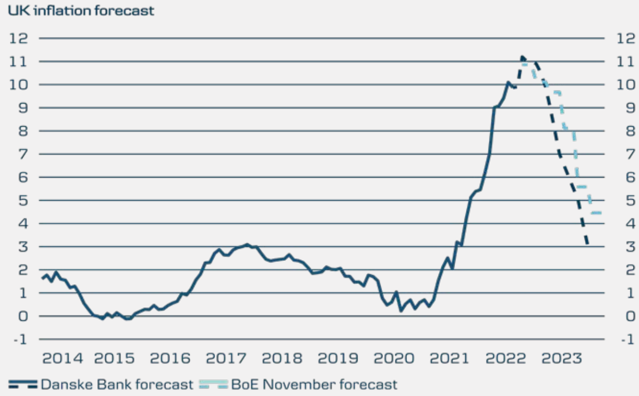
A large part of UK inflation can be explained by external factors and there are signs that the global inflation pressures are falling back. Bottlenecks have started to ease, the global food price indexes have moved lower and many commodity prices have turned negative in year-on-year terms. This should also ease the cost pressure in coming quarters. Although the glob-

GDP never reached the pre-Covid trend and will be lower from here



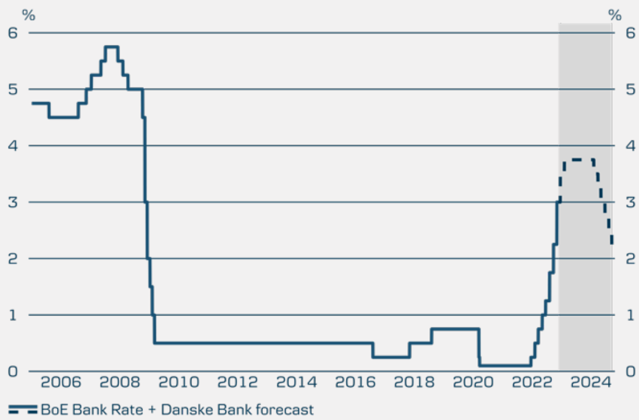
Source: Macrobond Financial, Danske Bank

Inflation to stay elevated during 2023



Source: ONS, Macrobond Financial, Danske Bank

No rate cuts during 2023



Source: Macrobond Financial, Danske Bank

al inflation pressure plays a large role, some domestic factors, including a tight labour market, is also part of the explanation. We expect that the peak in inflation will be seen in Q4 this year and that inflation then gradually will move lower during 2023, reaching 3.5% by the end of next year. This means that we expect UK inflation to be lower by the end of next year compared to the euro area, largely due to the energy price cap.

The end of Bank of England's hiking cycle closing in

Bank of England (BoE) delivered its biggest rate hike in 33 years during November bringing the Bank Rate to 3%. Despite delivering a historical rate hike, BoE once again pushed back against market expectations for the scale of future rate hikes, putting more emphasis on that the current markets rate path would induce a two-year recession for the UK economy. We expect BoE to deliver rate hikes during December and February with 50bp and 25bp, respectively, bringing the peak in the Bank Rate to 3.75%. The risk is skewed towards an additional rate hike in March 2023 if the inflation pressures remain intense or/if the economy surprises on the upside. Our base case is that BoE stays on hold after the February meeting and for the rest of the year. Due to our inflation forecast with inflation above 3% by the end of next year and that the BoE tends to be cautious, we do not expect the first rate cut until 2024 where we forecast that 150bp rate cuts will be needed. Our base case implies that we believe the current market pricing for the number of rate hikes in 2023 is too aggressive, markets are currently pricing in a peak at 4.6% i.e. almost 1p.p above our forecast.

Macro forecasts - UK

% change q/q	2022				2023				2024						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2022	2023	2024
GDP	0.7	0.2	-0.2	-0.3	-0.3	-0.4	-0.1	0.1	0.1	0.2	0.2	0.3	0.3	-0.7	0.8
Unemployment rate (%)	3.8	3.8	3.7	3.9	4.2	4.3	4.5	4.6	4.8	4.9	5.0	5.1	5.1	4.4	5.0
CPI (y/y)	6.2	9.2	10.0	10.3	9.7	6.4	5.2	3.5	3.0	2.7	2.5	2.3	2.3	6.2	2.6
BoE deposit rate[1]	0.75	1.25	2.25	3.5	3.75	3.75	3.75	3.75	3.25	2.75	2.25	2.25	2.25	3.75	2.6

1: End of period
Source: ONS, Bank of England, Danske Bank

Japan

The odd one out

- The economic recovery has been weak, largely hampered by Covid-19, but that leaves some potential for growth.
- Short-term, the economy will enjoy tailwinds from loosening supply chain issues, the weak yen and pent-up private spending. Another fiscal boost in 2023 will support growth, but a global recession will weigh heavy on exporters.
- Inflation is moving higher, but we expect a global recession will keep unions' focus on job security in the spring wage negotiations, obstructing a price-wage spiral.
- Our base case is that Bank of Japan's yield curve control remains in place, but the risk of an involuntary exit with potential large consequences to financial markets has increased significantly.

Lagging behind

Japan has missed out on the global economic recovery following the first reopening after Covid-19 lockdowns. The pandemic has weighed heavily on the cautious Japanese consumers and on the world's second largest car manufacturer, as supply constraints have been a key obstacle to production. Japan has shipped about 1 million fewer cars in 2020 and 2021 compared to 2019 and the recovery has just picked up slightly during H2 2022, but still far off the pre-pandemic levels of 4.4 million a year. The headwinds to the manufacturing sector have also spilled over to capex. In Q3 2022, GDP remained 2.9% below Q3 2019-levels, far behind the rest of the G7. Capex and private spending have been the key underperformers, and Japan has fallen back to old habits with public spending as a key growth driver. A strong trend in machinery orders bodes well for a recovery in corporate investments in the short-term, but a global recession will likely keep capex below pre-pandemic levels. For two years, households have saved extensively, as soft lockdowns continuously weighed on consumers. Only in Q2 when the lockdown was abolished did the savings rate decline. This also means that, consumers still have a lot of savings from the pandemic, which can be released if Covid-19 does not flare up again.

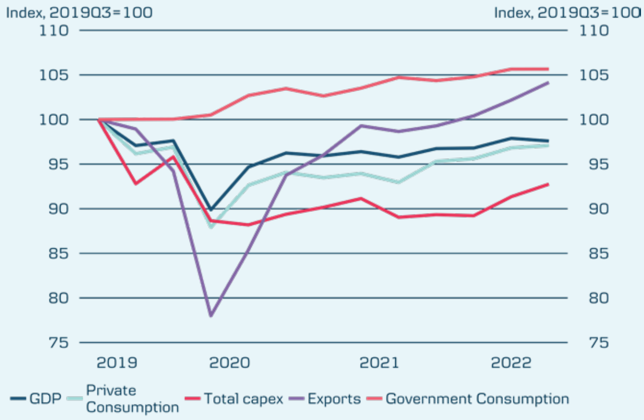
After another Covid-19 wave over the summer, the economy has hit a sweet spot in Q4 with a low number of new cases supporting the service sector. A historically weak yen is also boosting exports and supply chain bottlenecks are easing. That is also why we see Japan, at least to some extent, catching up with the global economy in Q4-Q1. Eventually, the slowdown in Japan's largest trading partners, US and China, will weigh on Japanese exporters who are largely sensitive to the global business cycle. A JPY39trillion (over 7% of GDP) supplementary fiscal package will shield consumers from the energy crisis and support the further recovery in Japan next year. However, fiscal packages like these have a history of not being fully used. With the government picking up large parts of the energy bills next year, we continue to see room for modest private consumption growth in 2023. That said, inflation will also weigh on Japanese consumers, which is aready reflected in low consumer confidence.

The Japanese labour market is notoriously tight, but reflects the weak recovery so far. That is, unemployment remains above old lows and the jobs-to-applicants ratio is far off the tightest levels in 2018 when there was more than 160 job openings for every 100 applicants.

Global recession gets in the way of reflation

As inflation and yields have surged on a global scale, the contrast to Japan has become still more evident. Headline inflation has increased significantly, but less dramatically compared to the US and the euro area. The Bank of Japan's (BoJ) preferred measure, CPI excluding fresh food, has hit the highest level since the early 1980s, weighing on consumers who have been used to very little price moves for many years. Price increases are spreading now and inflation excluding food and energy stands at 1.5%. This largely reflects a historically large shock to import prices and inflation still looks to have a temporary nature.

Still not caught up



Source: Japanese Cabinet Office, Macrobond Financial

The pandemic has been hard on car manufacturers

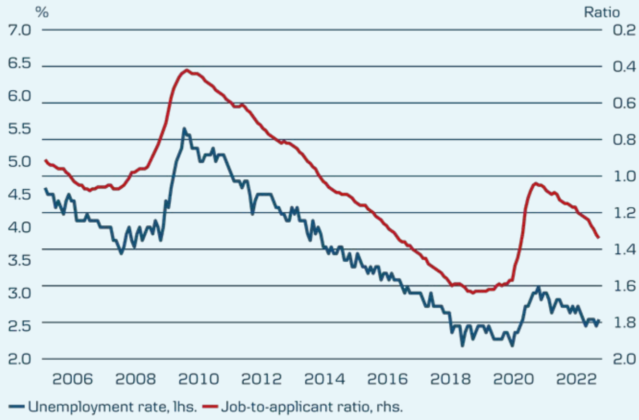
Source: Japan Automobile manufacturers association, Macrobond Financial

Large accumulated savings

Source: Japanese Cabinet Office , Macrobond Financial

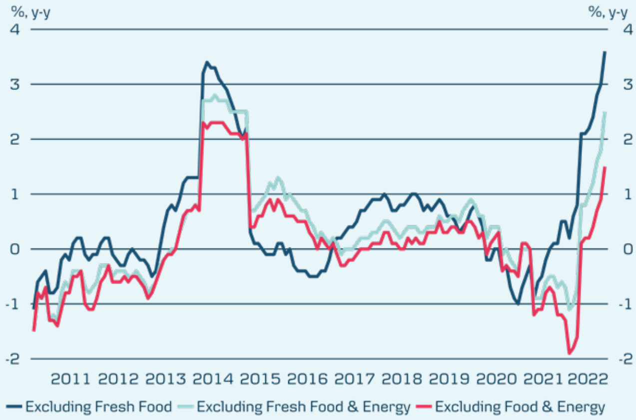
This delicate situation leaves BoJ as the odd one out among major central banks as they have fiercely defended their yield curve control (YCC) policy with massive bond buying. Japan's status as a major energy importer and the lack of tourists have driven a historical trade deficit. This has spiralled the yen to a 50-year low, adjusted for inflation. The BoJ has intervened several times in the FX market during the fall on behalf of the Ministry of Finance to support the yen. That leaves the BoJ pumping yen into the market with the one hand and buying them with the other. This is an unsustainable situation that could have serious repercussions for financial markets if the global pressure for higher yields forces the BoJ to give up on the YCC. See FX Research: Bank of Japan's Gordian knot. We still see this as a risk scenario, though, and our main scenario it that the YCC remains in place. The annual Shunto spring wage negotiations will show if companies are finally increasing workers' base pays by enough to potentially create a wage-price spiral, which is essentially what BoJ wishes for and what other central banks fear. We think the global recession will tip priorities towards job security and that will get in the way of any significant increase in wage growth and sustainable reflation. Springtime will be crucial for monetary policy in Japan, as the second and last terms of governor Kuroda and his two deputies run out. They are all fierce advocates of reflating the economy and the big question is, whether they will be replaced by doves or if the prime minister sees an opportunity to tweak BoJ leadership in a more hawkish direction.

Room for tighter labour market



Source: Japanese Statistics Bureau, Japanese Ministry of Labour and Macrobond Financial

Core inflation still modest but moving higher



Source: Japanese Statistical Bureau, Macrobond Financial

Historically weak yen

Source: Macrobond Financial

Macro forecasts - Japan

% y/y	2020	2021	2022	2023	2024
GDP	-4.7	1.7	1.4	0.7	0.9
Private Consumption	-5.9	1.1	3.0	0.9	0.8
Total fixed Investments	-5.0	-1.3	-0.8	1.3	0.6
Public Consumption	2.3	2.1	1.6	0.6	0.5
Exports	-11.7	11.9	4.7	2.5	1.5
Imports	-6.8	5.1	8.0	3.2	0.5
Unemployment rate (%)	2.8	2.8	2.6	2.8	2.8
CPI. excl. fresh food (y/y)	-0.2	-0.2	2.2	2.4	1.4
BoJ rate on deposit facility*	-0.1	-0.1	-0.1	-0.1	-0.1
10 year bond rate target*	0.0	0.0	0.0	0.0	0.0

*Note: *end-year*
Source: Macrobond Financial, Danske Bank

China

Struggle continues

- China faces three strong headwinds from a) zero-Covid policy, b) property crisis and c) fading exports as the US and Europe head for recession.
- Growth is set to stay below trend in the coming quarters before recovering in the second half of 2023, where we look for an end to the zero-Covid policy. We look for GDP growth at 3.3% in 2022 rising to 4.9% in 2023 and 5.3% in 2024.
- Inflation remains low in a global perspective, leaving room for continued stimulus. We look for measures to ease the property crisis to be stepped up.
- The US-China rivalry continues at unabated pace and China faces challenges from new significant US tech export restrictions.

Growth headwinds continue

After robust growth in 2021, the Chinese economy has struggled since the Covid-19 virus mutated into the more contagious Omicron variant at the end of 2021. Since then, China's dynamic zero-Covid policy has led to a frequent amount of local restrictions throughout the country, with the Shanghai lockdown in the second quarter of 2022 being by far the worst case that led to a sharp decline in GDP. While the economy rebounded in the third quarter of 2022, and we have not seen as severe lockdowns since then, the zero-Covid policy continues to be a drag on growth. It has also been a key factor contributing to weakness in home sales and keeping the property sector in a deep crisis.

Looking ahead, the Chinese economy continues to be held back by three headwinds:

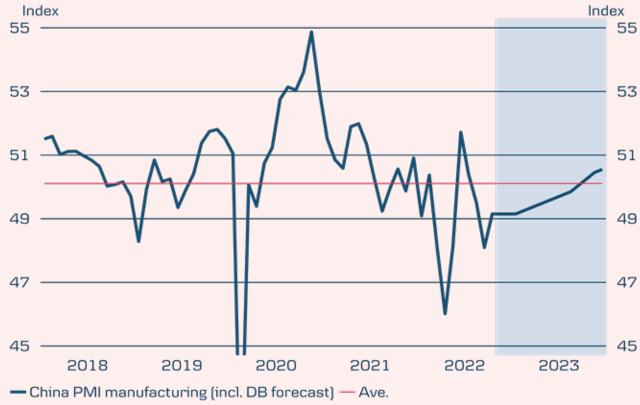
1. Zero-Covid policy (see box): The zero-Covid policy leads to many local restrictions on a frequent basis, which adds a lot of uncertainty to consumers and potential homebuyers. It also hampers the desire to start a new business and make investments in general. We look for the zero-Covid policy to be eased in the second half of 2023 (previously we expected an easing in the second quarter of 2023), which should ultimately pave the way for a lift to consumption and investments.
2. Property crisis: The stress in the housing market has continued throughout 2022 with little signs of easing. Policy easing thus far has mainly avoided a total meltdown, but it has not been able to drive a recovery. Recently China launched a new comprehensive easing package that should give some support to the property market in the short term. Once the zero-Covid policy is eased, we should start to see more clear improvement in home sales and construction from the current depressed levels, as we see cyclical pent-up demand for housing.
3. Global recession: Exports have been a strong engine of growth in the past two years while the US and Europe have ordered a lot of goods from China. However, with the two regions expected to move into recession, the Chinese export engine is starting to slow and is set to shift down further in 2023.

With few private growth engines left, we expect infrastructure stimulus to continue to play a key role in the coming quarters and keep a floor under Chinese growth around 4%. We also look for more aggressive measures to underpin housing. Our GDP forecast for 2022 is 3.3% year-on-year. This is clearly below trend, which we see around 5%. In 2023, we expect the economy to grow 4.9% followed by 5.3% in 2024 as we look for pent-up demand to be unleashed once China leaves the zero-Covid policy.

Low inflation leaves room for policy stimulus

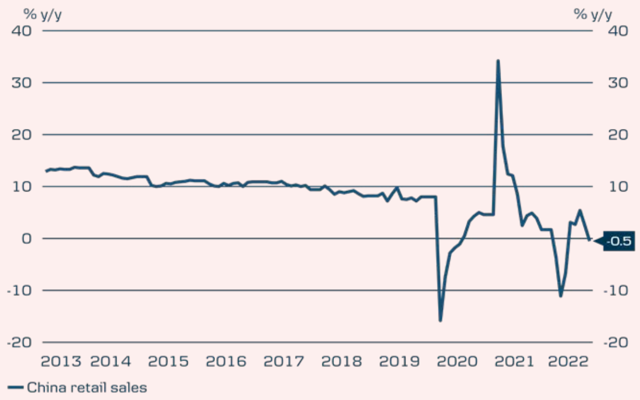
In contrast to most of the world, China's inflation has remained fairly low. For the past two years, inflation has been running below the 3% target and was 2.8% in September. The relatively low inflation reflects mainly two factors: first, China's private consumption has been weak for some time leaving little demand pressure and pricing power among retailers. Second, food price inflation that comprises around 1/3 of the basket, has been much more muted than elsewhere, as it is affected

Manufacturing growth to stay below trend until H2 2023



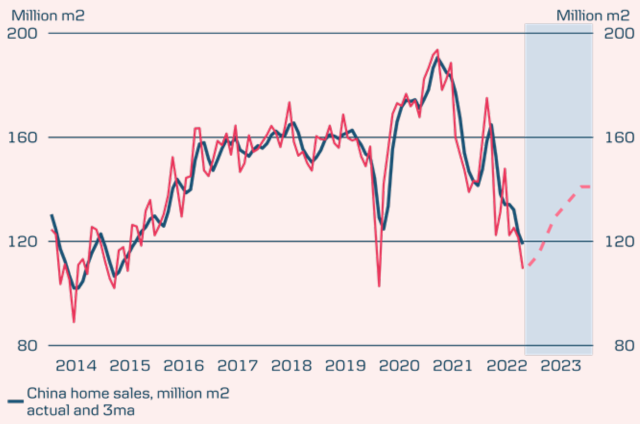
Source: Macrobond Financial, Markit, Danske Bank

Zero-Covid policy keeps consumption subdued



Source: Macrobond Financial, NBS, Markit, Danske Bank

Property crisis continuing as home sales still very weak



Source: Macrobond Financial, NBS, Danske Bank more by domestic factors such as the supply of pigs and local harvests. The development in that area has been favourable for price developments over the past years.

The low inflation has left room for a decent amount of stimulus, mostly via fiscal policy. Infrastructure spending has picked up and car sales were boosted by incentive schemes. However, the stimulus has only been able to put a floor under how low China's growth has fallen due to the extend of the headwinds. Looking ahead, we expect China to keep up the current degree of stimulus from infrastructure, but to do more to ease the property crisis with more forceful steps to lift home sales and improve financing for developers.

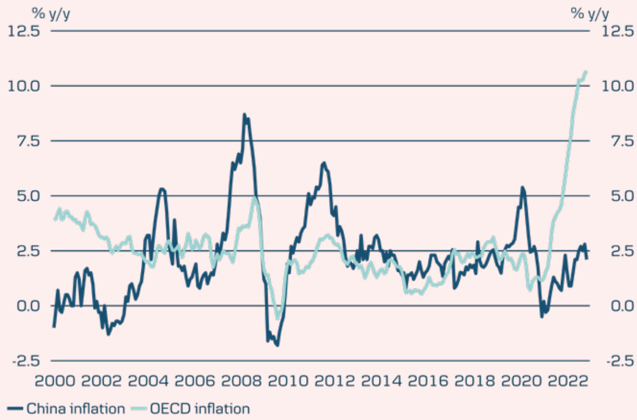
Xi cements power at CPC Congress

Chinese President Xi Jinping cemented his power at the 20th National Congress of the Communist Party in October as four new members in the Standing Committee of the Politburo are seen as Xi allies. There were no clear signs of the zero-Covid policy ending soon and Chinese shares dropped sharply afterwards. Xi's speech at the Congress highlighted the many challenges China is facing both domestically and externally, and put more emphasis on security and self-reliance than five years ago. However, Xi also stressed that economic development is China's top priority, as China will not be able to meet its goal of National Rejuvenation and common prosperity without continued economic development. China's economic path is set to continue on a hybrid economic path with a strong state sector constituting around 1/3 of the economy and private sector constituting the majority of the economy and being responsible for 90% of the job creation. Xi repeated unswerving support to the private sector and the market playing a decisive role in resource allocation. However, there are also signs that we will see more redistribution of income as part of the common prosperity agenda.

US-China rivalry is at a new high with an extensive US tech ban. The US and China are increasingly entering a cold war era, as the US is stepping up export restrictions to hold back Chinese technological development and building security alliances in Asia to counter China. In early October, the Biden administration put significant new export restrictions on the Chinese chip sector. While restrictions have previously been aimed at specific companies on the so-called 'entity list', the new export ban takes aim at the whole chip producing industry as well as the artificial intelligence (AI) and super computer sectors. It is a serious blow to China's self-reliance agenda within microchips and will also hold back development in AI and super computers.

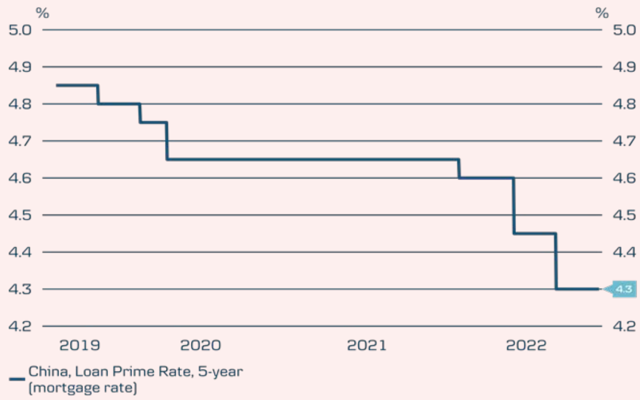
China has not retaliated to any of the previous restrictions, but at this scale, it can no longer be ruled out that China will hit back at some point. Export quotas on rare earth minerals are China's strongest weapon. However, we lean towards China still not firing any shots in the tech war as they have no interest in an escalation now. In the long run, the US could very well pay a price, though, when China has gained more technological strength. It may be decades away but China will work hard on climbing the technological ladder over the coming years and become independent of US tech companies and technologies.

Chinese inflation bucks the trend



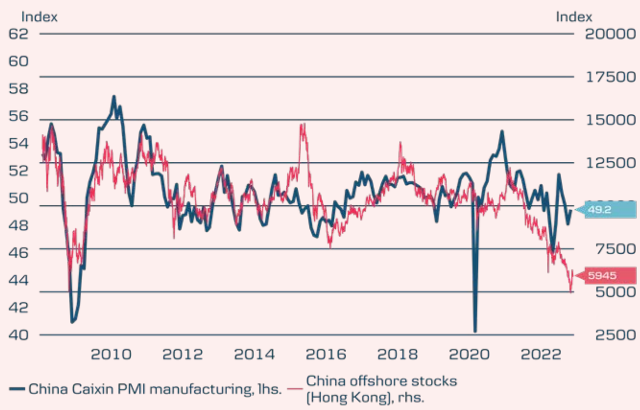
Source: Macrobond Financial, NBS, OECD, Danske Bank

Lower mortgage rates underpin housing



Source: Macrobond Financial, Danske Bank

Battered Chinese equities reflect China's many challenges and higher risk premia



Source: Macrobond Financial, Danske Bank

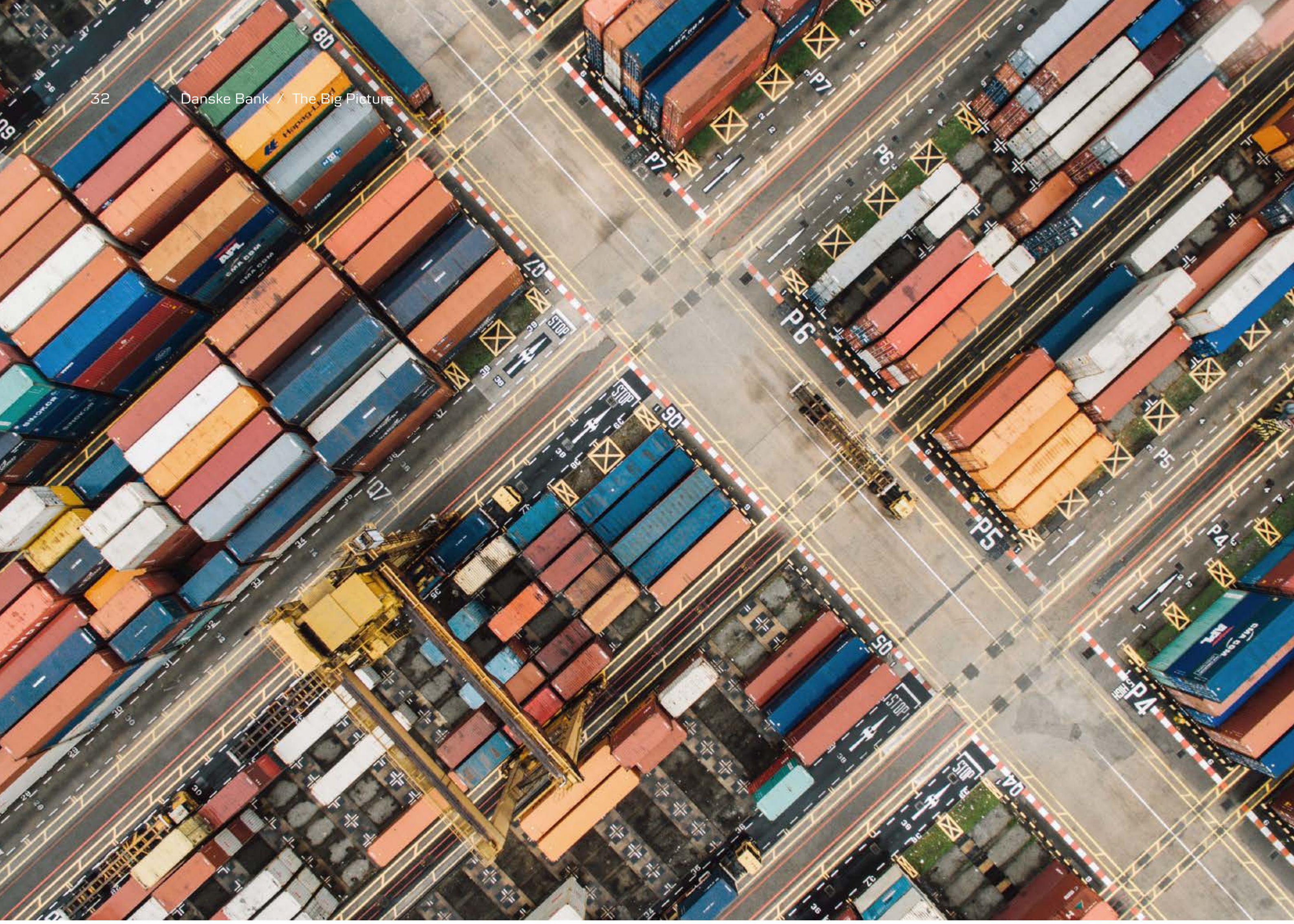
Macro forecasts - China

% y/y	2019	2020	2021	2022	2023	2024
GDP[1]	6.0	2.2	8.1	3.3	4.9	5.3
Private consumption[1]	6.3	-0.8	9.8	2.8	5.1	5.5
Investment[1]	5	4.6	5.2	4.5	5.2	5.5
Net exports[2]	-0.2	-0.7	0.5	-0.3	-0.3	-0.2
Total investment share[3]	43.3	43.4	42.8	43.2	43.2	43.2
Total savings rate [3]	43.8	44.5	44.4	46.4	44.2	44.0
Current account balance[3]	0.5	1.1	1.6	1.6	1.0	0.8
CPI[1]	2.9	2.5	0.9	2.0	2.2	2.5
Household income (real)[1]	5.0	1.0	3.5	3.0	5.0	5.5
Household savings rate. % of disp income	-6.1	-9.7	-6.1	-8.9	-7.2	-7.5
Wage growth (nominal. urban)[1]	56.1	66.3	68.9	76.9	84.1	89.8
Government budget balance[3]	-7.5	-6.8	-6.2	-5.6	-7.0	-6.8
General government debt[3]	53.8	56.1	66.3	68.9	72.0	74.5

Notes: 2022-2024 is forecast. 1: % y/y. 2: contribution % to GDP. 3: % of GDP activity plus excludes land sale proceeds
Source: IMF WEO, Danske Bank

When will China leave the zero-Covid policy?

On 10 November China issued 20 points with tweaks to the zero-Covid policy. The points included shortening quarantine for travellers entering China to '5+3' from '7+3, reducing test frequency for people and no longer tracking 'close contacts of close contacts'. However, the directions also underlined that officials should continue to conduct the 'dynamic zero-Covid policy' suppressing the spread of the virus. We believe it reflects an acknowledgement from Chinese leaders that the economic as well as social cost is rising and they now prepare the road to a full exit of the policy. However, we do not expect China will allow the virus to spread uncontrolled in the short-term. To minimize the health costs, it would not make sense to open up going into the winter, where cold weather increases contagion, and risks of overwhelming the medical system increase. However, we expect China to roll out a vaccination campaign during Q1 in preparation for leaving the zero-Covid policy over the summer when the season is more favourable to avoid a massive spread of the virus. Clearly this forecast is uncertain, so what should we look for? a) China's tolerance for the spread of the virus in coming months, b) approval of new mRNA vaccines c) roll-out of a vaccine campaign, and d) signals from health officials in Chinese media on how people should deal with the virus. The coming months will show how high China's tolerance is for bigger outbreaks. Will they allow waves to get bigger than what we have seen in the past? Will we see local governments refraining from 'hard lockdowns' and instead resort to warnings about going out and taking public transport etc. in areas with bigger outbreaks? Whether China opens up in Q1, Q2 or some point in the first half, we will likely see a short-term economic hit followed by a period of stronger demand once we are "on the other side". This is the pattern seen in South Korea, Hong Kong and Taiwan when they left a similar policy. It should raise growth once we are on the other side as it unleashes pent-up demand and China moves from a disinflationary force to an inflationary force for the global economy.



Emerging Markets

In the eye of the storm

- Large economies are heading into a recession at a time when most emerging economies have yet to fully recover from the pandemic-related economic shock.
- Tighter financial conditions imply higher financing costs for emerging economies, while a stronger US dollar increases the relative burden from USD-denominated debt.
- Several EM economies have already lost access to financial markets and more are likely to follow. More than ten countries have resorted to the IMF this year, seeking support for their balance of payments crises.
- We take a special focus on Latin America, where economic performance this year has been better than expected, many central banks resorted to pre-emptive tightening and a new leftist wave has swept across the continent.

In the context of tightening global financial conditions, a stagnating world economy and a stronger US dollar, we think emerging economies will struggle to catch up, especially those that were already lagging behind in the global post-pandemic recovery story. While headline inflation has peaked in low-income economies, where food and energy comprise a larger share in the consumption basket, it continues to rise in middle-income economies. Overall, the exceptionally wide differential in headline inflation rates between middle-income and high-income countries underlines how lower-income economies are disproportionately affected by the ongoing cost of living crisis.

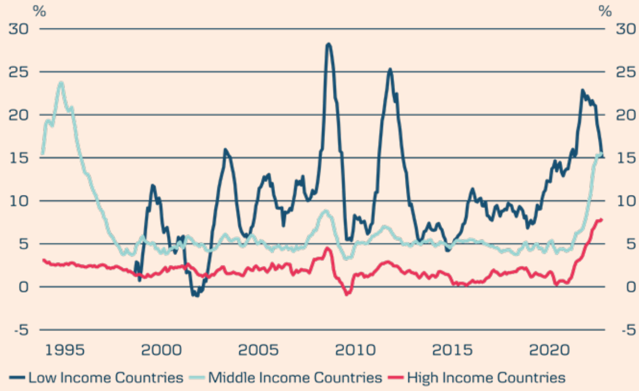
Tighter financial conditions affect EM economies through three channels: 1) financing costs rise following higher credit risk premia, 2) a stronger US dollar increases the relative burden from USD-denominated debt, and 3) access to funding deteriorates as foreign investors prefer low-risk assets that now yield positive nominal returns. In this context, EM economies with substantial external vulnerabilities such as high debt, budget and current account deficits and limited foreign reserves, face the highest risk of acute balance of payments or FX crises. Trade exposures, reliance on specific trading partners such as China or significant reliance on imported fuels add to FX vulnerabilities. Local central banks also play a key role, as too loose monetary policies imply negative real rates that tend to trigger capital outflows.

Since the onset of Russia's war of aggression against Ukraine, at least 13 countries have resorted to the IMF and have received, or are set to receive, support for their balance of payments crises. According to the World Bank, nine emerging market (EM) economies are in acute debt distress and almost 30 countries face high risk of such. With a few exceptions, these are Sub-Saharan economies. Yet, fiscal space is also very limited in G20 emerging economies, such as Brazil, India and South Africa, where budget deficits and debt levels remain elevated after the pandemic. Excluding the very low-income economies, the most exposed EM economies in our view currently include Turkey, Poland, India, Pakistan and Egypt[1]. In contrast, most Latin American countries, as well as Malaysia, Indonesia and Vietnam, despite each having some vulnerabilities, rank among the least exposed.

In the longer term, some EM economies are set to benefit from businesses and investors diversifying away from their exposure to China. The reshuffling of supply chains is likely to benefit economies with sufficient supply of affordable yet skilled labour and economies that foster an enabling business environment with limited political (and sanction) risk. In our view, some economies particularly in Eastern Europe and in Southeast Asia pose significant potential for alternative production locations.

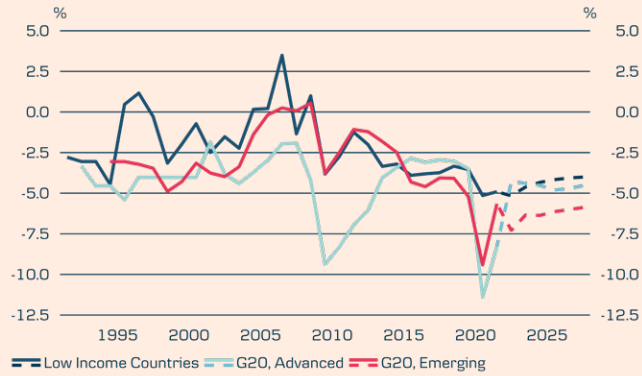
[1] *excluding small economies, such as Sri Lanka. Note, the analysis has been conducted to a selected group of Danske Bank's core emerging markets.*

Headline inflation has peaked in low-income countries but continues to rise elsewhere



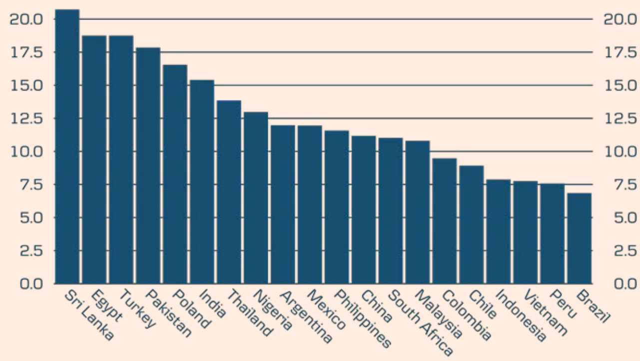
Source: World Bank Global Economic Monitor, Macrobond Financial, Danske Bank

G20 emerging economies have very limited fiscal space to compensate for citizens amidst the cost of living crisis



Source: IMF Fiscal Monitor, Macrobond Financial, Danske Bank

Higher score implies greater vulnerability to external conditions



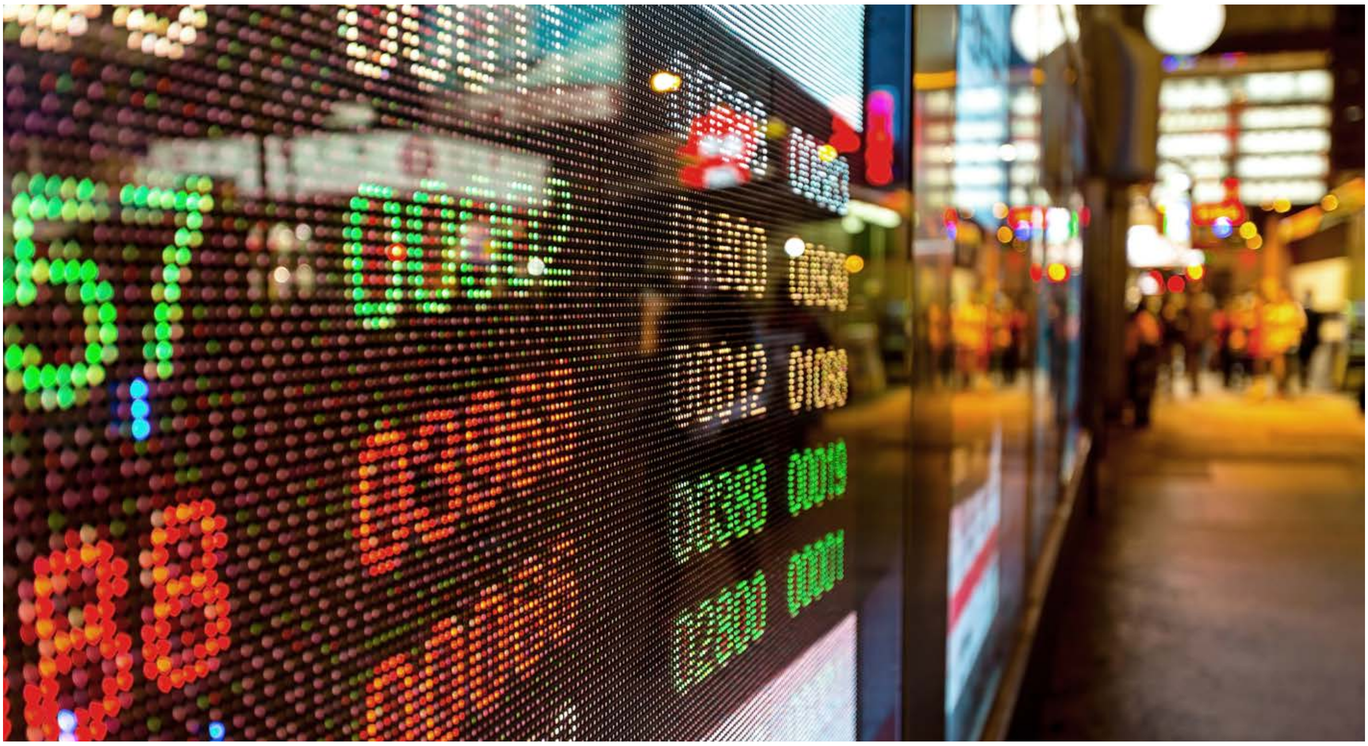
Source: Macrobond Financial, Danske Bank calculations

Is Latin America getting it right for once?

The Latin American region is infamous for its chronic sovereign debt problems and striking inequality. With the exception of Mexico, who has managed to climb up in global value chains, most Latin American economies continue to depend on commodity exports, which makes their economic performance volatile. Commodity reliance also implies heavy exposure to China, whose manufacturing industry is the driving force for global raw material demand. Hence, when looking for a model example of a country running sound economic policies, one would tend to look anywhere but Latin America.

Despite the factors mentioned above and thanks to high commodity prices, Latin America has outperformed this year. In the four largest economies (Brazil, Mexico, Argentina and Colombia), GDP growth has exceeded expectations. The Brazilian real, despite the political risk associated with the recent presidential election, is the best year-to-date performer in the EM FX space. Then comes the Mexican peso, which by mid-November had gained 5% against the US dollar. These currencies' remarkable resilience amidst the broad USD strength underlines the importance and the success of the pre-emptive monetary policy tightening conducted by local central banks, which started hiking rates well before the Fed. Brazil hiked already in March 2021; Mexico, Colombia and Chile all followed in the second half of 2021. Unlike Western economies, these economies now run close-to-neutral or positive real rates and in Brazil core inflation seems to have peaked.

Does the 'lesson learning' extend to politics? A fresh 'pink tide' has swept across the region, as left-of-centre candidates have been elected in Mexico, Argentina, Peru and Chile in recent years. This year brought the first-ever leftist leader in Colombia, while Brazil, under the leadership of Lula, is now the latest to turn left. The 'new Left', largely, is striving to distance itself from the 'old Left' and the likes of Cuba and Nicaragua. Climate and social justice are at the core of their agenda. Many Latin American economies supply raw materials that are crucial for the global green transition and electrification of societies, such as metals and critical minerals. In Brazil and Colombia, and broadly across the region, the share of renewables in electricity production is already high (above 60%). Hence, in a region, where decades of efforts to reduce poverty and inequality have been watered down by incompetent policies and corrupted politicians, more inclusive economic policies may now resonate with foreign investors more than ever. That is as long as fiscal discipline remains. Talk is cheap, and implementation is the hard part. The new Left shows promise, but is yet to prove they are any better and more capable than their predecessors.



Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Heidi Schauman, Global Head of Research, Allan von Mehren, Chief Analyst, Minna Kuusisto, Chief Analyst, Aila Mihr, Senior Analyst, Bjørn Tangaa Sillemann, Senior Analyst, Antti Ilvonen, Analyst and Therese Persson, Analyst.

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Expected updates

Ad hoc

Date of first publication

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